Fed Watch

US | The Fed signals multiple hikes in 2023 and suggests policy rate might peak above 5%

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FOMC shifts down from 75bp hikes but signals a more hawkish outlook, keeping an eye on non-housing core services inflation

- **The Fed raised the fed funds rate by 50 bps to a 4.25-4.50% target range**, shifting down the pace from the prior four consecutive 75bp hikes, as telegraphed over recent weeks and widely expected by financial markets and analysts, us included (see). The wording of the statement was virtually unchanged. **The fact that the Fed did not drop the "ongoing increases" language[1] suggests that the Fed is planning on hiking rates multiple times (at least two) next year.** This was reinforced by both the updated "dot plot" and Chair Powell's hawkish remarks, which together strongly point to strong support for further tightening.

- **The updated Summary of Economic Projections (SEP) outlined a somewhat weaker economic scenario aligned with the more hawkish projected policy stance** (Table 1). Real GDP growth for this year was slightly revised up to 0.5% (0.2% in September) after a better than expected 3Q22. However, the median FOMC participant now expects the US economy to expand by 0.5% in 2023 (down from 1.2% in September). GDP growth for 2024 was barely revised down to 1.6% (1.7% in September), while the expectation for 2025 was unchanged. The unemployment rate is now expected to tick up to 4.6% for 2023 and 2024 (up from the September 4.4% projection for both years), and to marginally return to 4.5% in 2025. In spite of recent positive inflation signs, core PCE inflation forecasts for end-2023 were revised to 3.5% (up from 3.1% in September) and to 2.5% (up from 2.3%) for end-2024. **The median estimate for the fed funds rate by the end of 2023 was revised up from 4.6% in September to 5.1%. This suggests a hawkish outlook with 75bp worth of additional tightening (likely?) to come.** Moreover, seven participants expect an even higher peak for rates and only two think the peak should be lower than 5.0%. Year-end rate projections for 2024 and 2025 were revised slightly up to 4.1% and 3.1%, from 3.9% and 2.9%, respectively (Figure 1).

- **Chair Powell's remarks following the decision were unequivocally hawkish: "[...] we have more work to do."** Although Powell acknowledged and welcomed the recent inflation easing ("the inflation data received so far for October and November show a welcome reduction in the monthly pace of price increases"), he downplayed it, warning that "it will take substantially more evidence to give confidence that inflation is on a sustained downward path." In the Q&A section of the post-meeting press conference, Chair Powell explained that one of the reasons for the revised expectation of a higher terminal rate has to do with the expected behavior of non-housing related core services inflation, which "is likely to take a substantial period to get down" as it is more related to the labor market tightness, despite that core goods inflation has begun to show signs of relief. Furthermore, although he signaled that the bulk of the needed rate hikes was probably already made, additional tightening is on the cards: "we've covered a lot of ground and the full effects of our rapid tightening

[1] "The Committee anticipates that **ongoing increases** in the target range will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time."

so far are yet to be felt. Even so, we have more work to do." In addition, Chair Powell insisted on the importance of holding rates at a sufficiently restrictive level for a long period.

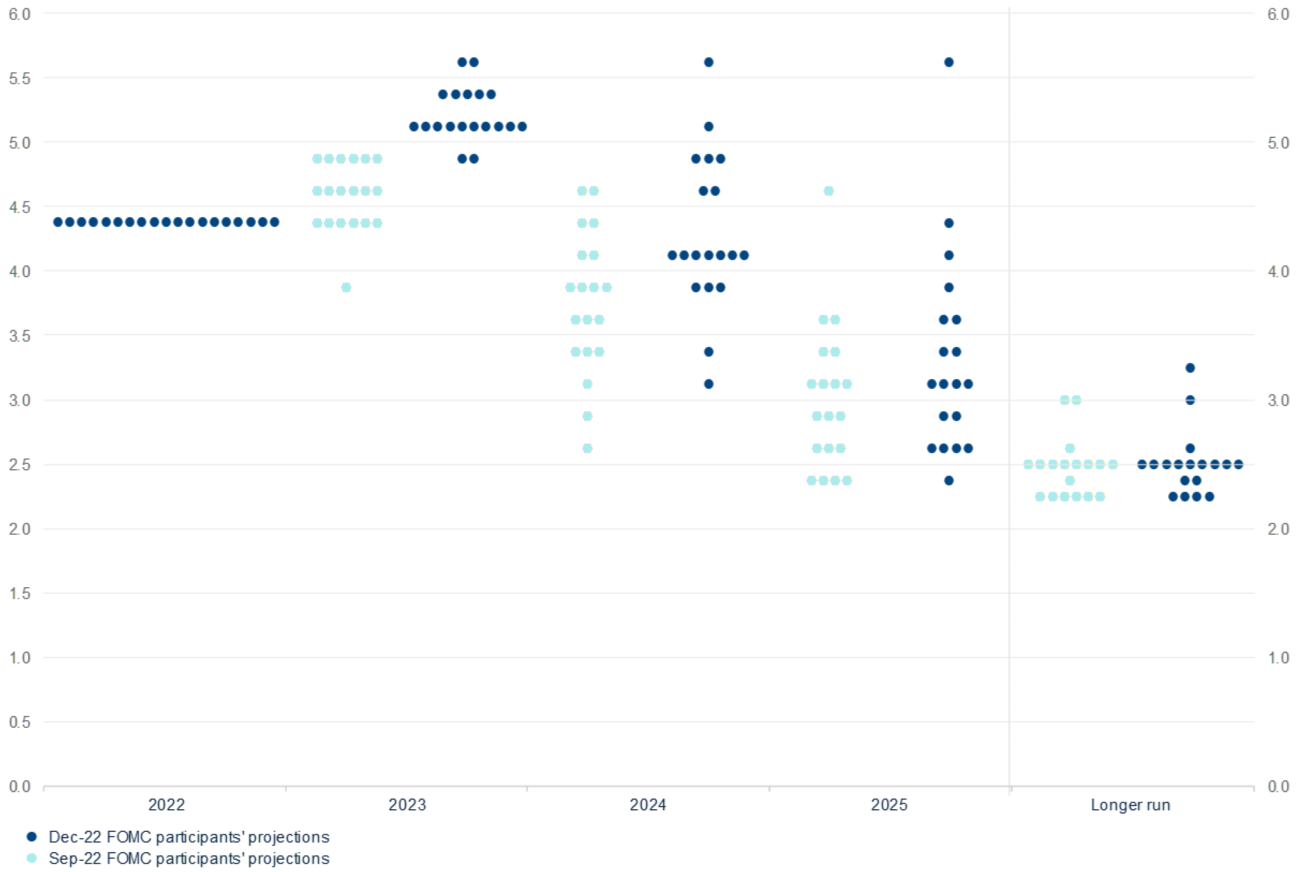
- **Today's hawkish signs indicate that, although inflation is starting to show clear signs of easing, the Fed felt a strong need to reverse the recent decline or avoid a further easing of rates along the yield curve.** Although explicitly questioned, Chair Powell avoided signaling that the Fed is uncomfortable with the easing of financial conditions that has occurred after the positive inflation data of recent months, as he only indicated that the Fed's "focus is not on short-term moves but on persistent moves", which could likely mean that the Fed expects financial conditions to reverse its path or at least not continue easing. For now, we stick to our call for two 25bp rate hikes in 1Q23, with the fed funds rate peaking at 4.75-5.00%.

Through the updated SEP and the accompanying dot plot, the Fed signaled 75bp worth of additional hikes and a weaker economic outlook, consistent with this more restrictive stance

Table 1. **FOMC PARTICIPANTS' SUMMARY OF ECONOMIC PROJECTIONS** (DECEMBER 2022, %)

Variable	Median					Central tendency					Range				
	2022	2023	2024	2025	LR	2022	2023	2024	2025	LR	2022	2023	2024	2025	LR
Change in real GDP	0.5	0.5	1.6	1.8	1.8	0.4-0.5	0.4-1.0	1.3-2.0	1.6-2.0	1.7-2.0	0.2-0.5	-0.5-1.0	0.5-2.4	1.4-2.3	1.6-2.5
Sep-22	0.2	1.2	1.7	1.8	1.8	0.1-0.3	0.5-1.5	1.4-2.0	1.6-2.0	1.7-2.0	0.0-0.5	-0.3-1.9	1.0-2.6	1.4-2.4	1.6-2.2
Unemployment rate	3.7	4.6	4.6	4.5	4.0	3.7	4.4-4.7	4.3-4.8	4.0-4.7	3.8-4.3	3.7-3.9	4.0-5.3	4.0-5.0	3.8-4.8	3.5-4.8
Sep-22	3.8	4.4	4.4	4.3	4.0	3.8-3.9	4.1-4.5	4.0-4.6	4.0-4.5	3.8-4.3	3.7-4.0	3.7-5.0	3.7-4.7	3.7-4.6	3.5-4.5
PCE inflation	5.6	3.1	2.5	2.1	2.0	5.6-5.8	2.9-3.5	2.3-2.7	2.0-2.2	2.0	5.5-5.9	2.6-4.1	2.2-3.5	2.0-3.0	2.0
Sep-22	5.4	2.8	2.3	2.0	2.0	5.3-5.7	2.6-3.5	2.1-2.6	2.0-2.2	2.0	5.0-6.2	2.4-4.1	2.0-3.0	2.0-2.5	2.0
Core PCE inflation	4.8	3.5	2.5	2.1		4.7-4.8	3.2-3.7	2.3-2.7	2.0-2.2		4.6-5.0	3.0-3.8	2.2-3.0	2.0-3.0	
Sep-22	4.5	3.1	2.3	2.1		4.4-4.6	3.0-3.4	2.2-2.5	2.0-2.2		4.3-4.8	2.8-3.5	2.0-2.8	2.0-2.5	
Federal funds rate	4.4	5.1	4.1	3.1	2.5	4.4	5.1-5.4	3.9-4.9	2.6-3.9	2.3-2.5	4.4	4.9-5.6	3.1-5.6	2.4-5.6	2.3-3.3
Sep-22	4.4	4.6	3.9	2.9	2.5	4.1-4.4	4.4-4.9	3.4-4.4	2.4-3.4	2.3-2.5	3.9-4.6	3.9-4.9	2.6-4.6	2.4-4.6	2.3-3.0

Figure 1. **FOMC PARTICIPANTS' PROJECTED APPROPRIATE FEDERAL FUNDS RATE** (%)



Source: BBVA Research based on data by the Federal Reserve and Haver Analytics.

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